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Introduction to U.S. Economy: Consumer Spending

Consumer spending is a key driver of short-run economic growth in the U.S. economy. During the initial months of the Coronavirus Disease 2019 (COVID-19) pandemic, consumer spending dropped at a rapid and historic rate. This In Focus provides an overview of consumer spending, summarizes recent trends, describes its relationship with the business cycle, and discusses policy that can impact and be affected by consumer spending.

How Consumer Spending Is Measured

As defined by the Bureau of Economic Analysis (BEA), consumer spending, also referred to as personal consumption expenditures (PCE), is the value of the goods and services purchased by, or on the behalf of, persons (households and nonprofit institutions serving households) living in the United States. PCE comprises roughly two-thirds of gross domestic product (GDP) and is therefore typically a large component of short-run economic growth.

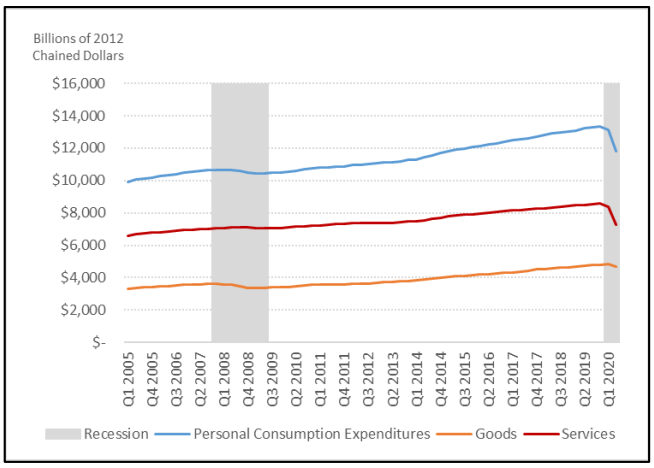
BEA provides PCE data monthly and measures these expenditures in relation to personal income and prices. Transactions included in the calculation of PCE consist largely of the purchases of new goods and services by households, among others. BEA measures the values of expenditure transactions, including sales and excise taxes. Measuring consumption expenditures against income allows for a comparison of how much consumers spend versus save. Tracking what people buy and how much they spend allows BEA to also track fluctuations in price levels, referred to as inflation in the case of rising prices. One of the most widely used sources for measuring inflation is BEA's PCE Price Index. Real PCE (PCE adjusted for inflation) is calculated by adjusting PCE by the price index.

Recent Trends in Consumer Spending

Figure 1 shows the pattern of real PCE in the United States between the first quarter of 2005 and the second quarter of 2020. The total personal consumption expenditure data is additionally shown broken out into spending in two main categories, goods and services. Expenditures of both goods and services have increased steadily since 2005, except during the financial crisis and recession of 2007-2009 and the current recession caused by the COVID-19 pandemic. Expenditures on services were consistently 30%-50% higher than expenditures on goods until 2020, when that gap began to close due to falling expenditures on services.

In 2020, PCE dropped by a non-annualized 6.6% in March and 12.6% in April—notably large monthly decreases. Still, real PCE remained higher in the second quarter of 2020 than in any single quarter of the 2007-2009 recession, although the magnitude of the difference is smaller when population is accounted for. The majority of the drop in total PCE was due to a decline in spending on services, a result of business closures, social distancing, and other measures taken to limit the spread of the virus.

Figure 1. Real Personal Consumption Expenditures
Q1 2005 - Q2 2020



Source: Bureau of Economic Analysis (BEA).
Note: Seasonally adjusted at annual rates.

Consumer Spending and the Economy

Patterns of consumer spending can be linked closely with broader economic conditions, specifically the business cycle and economic growth.

The Business Cycle and GDP

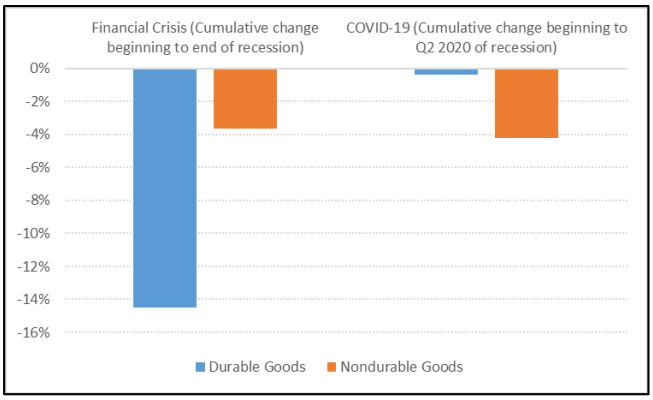
Consumer spending generally follows the pattern of the business cycle. During economic downturns, consumer spending typically decreases as unemployment increases and personal income decreases. In contrast, during expansions, consumer spending increases as unemployment decreases and personal income increases. A strong economy can impact consumer sentiment and spending. Consumer confidence due to economic conditions may increase purchases of durable goods (goods that can be used over a long period of time), such as vehicles or major appliances.

In general, spending on durable goods is more cyclical than spending on nondurable goods (goods that are "single use" or are consumed over a short period of time). Therefore, spending on durable goods should decrease relatively more in a recession as, in theory, individuals have the ability to put off big purchases, such as household appliances, until the economy improves or the need becomes sufficiently urgent.

Although this pattern has held in previous recessions, expenditures on nondurable goods have experienced a larger decline than spending on durable goods in the current

COVID-19 recession. **Figure 2** illustrates the percent change in expenditures on durable and nondurable goods from beginning to end of the 2007-2009 recession and thus far in the current recession. The spending pattern during the 2007-2009 financial crisis followed the traditional pattern and showed a larger decrease in spending on durable than nondurable goods. The current recession shows the opposite—the nature of the public health crisis halted spending on many nondurable goods, such as gasoline for a car, more so than on durable goods, such as a refrigerator or washing machine. Swift action by the Federal Reserve to lower interest rates and the economic impact payments that went to a portion of the population may have helped bolster spending on durable goods.

Figure 2. Cyclicality of Spending on Goods



Source: CRS calculations based on BEA data.

Consumer Spending and Monetary Policy

Interest rates can affect consumer decisions, largely in that they provide a trade-off between saving and spending. Higher interest rates give consumers a greater incentive to put money in, for example, a savings account to earn interest. Lower interest rates reduce the cost of borrowing, encouraging consumers to use credit to make big purchases, such as buying a car. Reducing short-term interest rates is the first tool the Federal Reserve uses in an economic downturn in an attempt to stimulate interest-sensitive spending, such as spending on consumer durables.

Consumer Spending and Fiscal Policy

Fiscal policies that directly address aggregate demand or income are likely to at least indirectly affect consumer spending. Aggregate demand is the total demand for all finished goods and services in the economy. In the short-term, when total aggregate demand falls, it creates recessionary conditions in an economy, often resulting in a decrease in consumer spending as well.

Policy Tools

Three main types of fiscal policy can be employed to increase aggregate demand during a recessionary period—increases in government spending, decreases in taxes, and increases in direct transfers. Taxes and transfers both directly affect personal disposable income, meaning that they will also directly affect consumer spending, and through this change, will affect aggregate demand. In contrast, government spending affects personal income and spending indirectly, through its effect on aggregate demand and the broader economy. How effective fiscal policy is at changing aggregate demand relies on how directly it affects aggregate demand and the extent to which it stimulates consumer spending.

Marginal Propensity to Consume

The marginal propensity to consume (MPC) is an economic concept that measures how much of one additional unit of disposable income an individual will consume, or spend. For example, if an individual were to receive one extra dollar of disposable income, and spent 60 cents of that dollar, that individual would have an MPC equal to 0.6. MPCs vary across individuals based on characteristics such as income and preference. Even though a theoretical construct, MPCs can be a useful tool to policymakers as they help determine how much a policy will affect consumer spending, and, ultimately, GDP.

Theory states that changes to government spending will have a larger impact on GDP than changes to taxes or transfers. A change in government spending has a direct one-to-one impact on GDP and a secondary effect on GDP in the form of any consumer spending or private investment it engenders. A change in taxes or transfers direct impact on GDP will be less than one-to-one, by the factor of the MPC, as individuals are not likely to put all of the money received back into the economy. For example, a decrease in taxes would result in an increase in personal income and an increase in spending by some amount less than the increase in income, as some amount will be saved. As with government spending, changes in taxes or transfers will have secondary effects on consumer spending and private investment, and therefore, in any case the effect on GDP is multiplicative.

Targeting tax and transfer measures to individuals with higher MPCs could result in higher multipliers. For example, low-income individuals tend to have relatively high MPCs as they tend to get more utility from an extra dollar of spending than a high-income individual would. This largely held true with the recent example of the economic impact payments—direct transfer payments made to individuals as part of the stimulus. An August working paper from the National Bureau of Economic Research, *How Did U.S. Consumers Use Their Stimulus Payments*, found that lower-income individuals were much more likely to spend most or all of their payments as compared with their higher-income counterparts.

Although higher MPCs can make it easier to recover from a recession, very high MPCs do not necessarily engender long-run economic growth, as saving is a determinant of long-run growth. What is not consumed is saved, and therefore relatively high rates of consumption lead to relatively low rates of saving. For a more in depth discussion of the relationship between long-run saving and growth, see CRS In Focus IF10963, *Introduction to U.S. Economy: Personal Saving*, by Marc Labonte.

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